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BANKING UNION: A SOLUTION TO THE EURO ZONE CRISIS?

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Banking union: a solution to the euro zone crisis?

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Summary: The banking union emerged from the June 2012 European Council as a new project expected to help and solve the euro area crisis. Is banking union a necessary supplement to monetary union or a new rush forward? The banking union would break the link between the sovereign debt crisis and the banking crisis, by asking the ECB to supervise banks, establishing common mechanisms to solve banking crises, and encouraging banks to diversify their activities. The banking union project is based on three pillars: a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM), a European Deposit Guarantee Scheme. Each of these pillars raises specific problems. Some are related to the current crisis (can deposits in euro area countries facing difficulties be guaranteed?); some other are related to the EU complexity (should the banking union include all EU member states? Who will decide on banking regulations?), some other are related to the EU specificity (is the banking union a step towards more federalism?), the more stringent are related to structural choices regarding the European banking system. The banks' solvency and their ability to lend would primarily depend on their capital ratios, and thus on financial markets' sentiment. The links between the government, firms, households and domestic banks would be cut, which is questionnable. Will governments be able tomorrow to intervene to influence bank lending policies, or to settle specific public banks? An opposite strategy could be promoted: restructuring the banking sector, and isolating retail banking activity from risky activities. Retail banks would focus on lending to domestic agents, and their solvency would be guaranteed because they would not be allowed to run risky activity. Can European peoples leave such strategic choices in the hands of the ECB?

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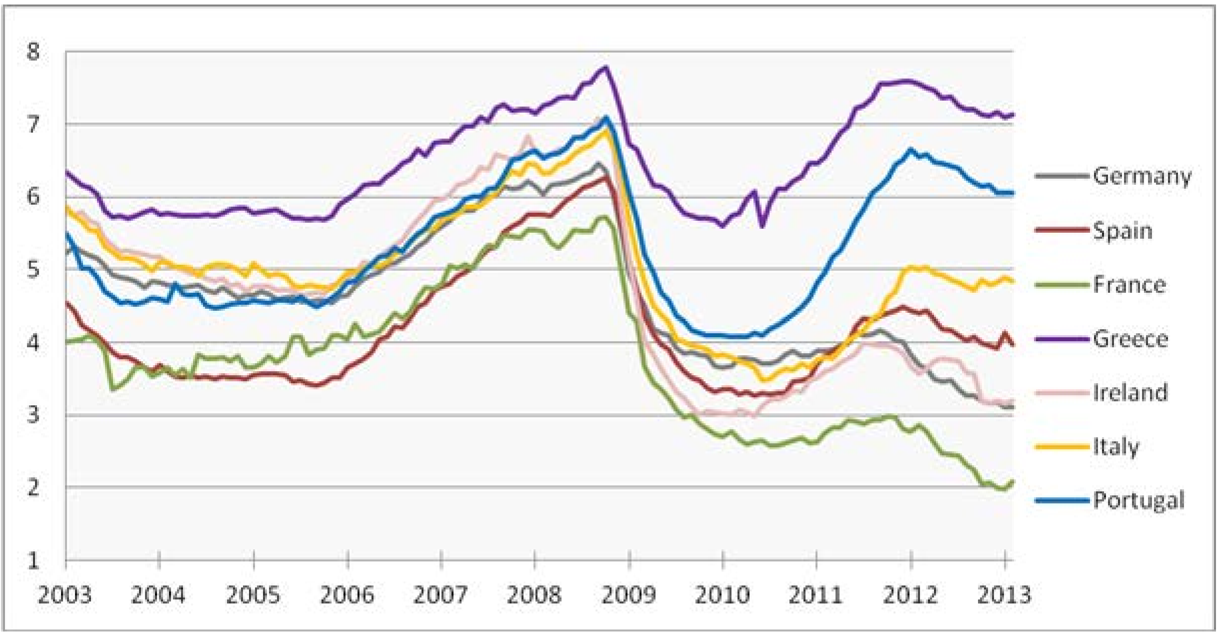
1. Introduction

Since early 2010, the European authorities have tried to find ways to overcome the public debt crisis in the euro area. This crisis revealed the deficiencies in the organisation of the area which led to a rise in imbalances between euro area countries from 1999 to 2007 and to their inability to define a common economic strategy after the 2008 financial crisis. The 28-29 June 2012 European Council was a new attempt from European bodies and member countries to solve the euro area crisis. A new project emerged: the banking union, which was more precisely defined at the 13 December 2012 Summit. Is banking union a necessary supplement to monetary union or a new rush forward?

The current crisis is mainly a banking crisis. Prior to the crisis, European banks had fed the rise in financial and real estate bubbles (especially in Spain and Ireland); they had invested in risky investment or hedge funds in the US; they were making a significant part of their profits in financial markets, but were risking their own funds. They experienced significant losses with the 2007-2009 crisis and the bubbles crashes. Governments had to come to their rescue, which was particularly costly for Germany, the UK, Spain and above all for Ireland. The euro zone sovereign debt crisis increased banks' difficulties; public debts which they held became risky assets. A dangerous resonance appeared between the difficulties of public finances and those of the banks of the same country. Doubts on public debts weaken national banks which generally own a certain amount of government bonds; markets consider that the governments will have to rescue their banks, which increases the fears on their own solvency and on their capacity to support their banks. Mistrust grows in an uncontrollable vicious circle. Last, the debt crisis destroyed the euro zone unity and the notion of 'single currency': a Spanish company cannot borrow at the same interest rate as a German company (figure 1).

Figure 1. Interest rates on short-term loans to non-financial companies



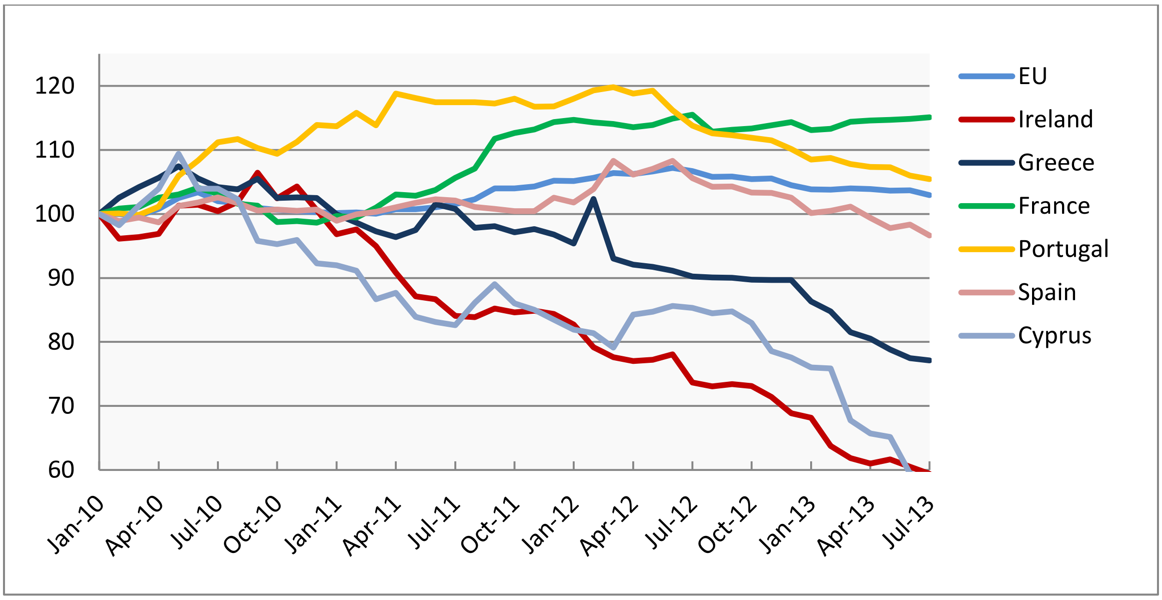
Source: ECB.

Due to the liberalisation of capital movements, small countries (Ireland, Iceland and Cyprus) were able to develop banking systems far too big for their size, and are unable to rescue them. Banking regulation is questioned at the international level (new Basel III standards), in the United States (Volker rule and Dodd-Frank Act) and in the United Kingdom (Vickers' report).

In June 2012, the robustness of European banks was once again questioned. The measures taken since 2008 to stabilise the financial system appeared insufficient. When Bankia, the fourth bank in Spain requested a EUR 19 billion support from the Spanish government, concerns on Spanish banks' balance sheets strongly rose. The share of bad debts in Spanish banks, whose balance sheets have been weakened by the burst of the housing bubble, rose from 3.3% at the end 2008 to 8.7% in June 2012, and 11.3% at the end of 2012 (according to the Bank of Spain). Furthermore, many European depositors reduced their domestic bank deposits fearing their country could leave the euro zone: during the first half of 2012, bank deposits fell by 5.6 % in Greece, 12% in Ireland, 4.5% in Portugal. From June 2012, this started also to occur in Spain: bank deposits declined by EUR 90 billion in the summer. The TARGET 2 system automatically re-lended to Spanish banks the Spanish deposits held in German banks, but the ESCB was thus playing a role of guarantee of Southern countries' banking systems, which could prove dangerous and raised the concerns of German politicians and economists.

Figure 2: Bank deposits

Basis 100=01/01/2010



Source: ECB.

In May 2012, in response to these risks, Mario Monti re-launched the objective of a European banking union, taking up projects already in preparation at the DG Internal Market and Services of the European Commission. Germany was reluctant, considering that there can be no banking union without fiscal union. Even though Angela Merkel acknowledged that it was important to have European supervision with a supranational banking authority, she refused that Germany takes the risk of new transfers or guarantees, without enhanced budgetary and political integration. However, the banking union project received the support of the European Commission, the ECB, and several countries (Italy, France, Spain...), some wishing to accelerate the move towards a federal Europe, some others looking for a lifeline emergency. Thus, the need for urgent action to save the euro zone could have heavy consequences, with reforms implemented too rapidly.

However on 29 June 2012, the euro area summit accepted that the Commission make proposals for a single supervisory mechanism (SSM) for euro area banks. Its implementation would allow the European Stability Mechanism (ESM) to directly recapitalise banks, thus breaking the vicious circle.

On 18 October 2012, the Council decided to launch the legislative work on a banking union while insisting on the need to strengthen the surveillance of fiscal policies (*six-packs*, *two-packs*, TSCG), by the monitoring of macroeconomic imbalances and by more incentives for structural reforms.

The 13 and 14 December 2012 the Council agreed on the Single Supervisory Mechanism (SSM), which would allow launching a consultation with the European Parliament; the initial objective was to reach an agreement on the deposit guarantee and on the resolution mechanism by mid-2013 but the debate are still going on in autumn 2013.

On June 2013, the Council agreed on the Bank Recovery and Resolution Directive (BRRD) proposed by the EU Commission in June 2012, which open the road to its vote by the European Parliament.

The 12 September 2013, the European Parliament voted to set up the SSM, giving to the ECB the full responsibility for the European banks supervision. These powers will be effective in September 2014.

By entrusting bank supervision at the European level, by implementing common mechanisms of deposit guarantee, of banking crises resolution, by encouraging banks to diversify in Europe, the banking union would, according to its proponents, break the correlation between sovereign debt crisis and banking crisis. It would help to unify credit and deposit markets in Europe. Conversely, it would introduce in each country a break between banks on the one hand, governments and national companies on the other hand. It would be a new step towards federalism by a new transfer of competence from the Member States to European authorities. The project raises again unresolved issues: can we have an economic and monetary union without fiscal and political union? Do the European integration has any limit? How to take national differences into account?

Can banking union offset four major drawbacks of the Monetary Union: the absence of a "lender of last resort" which allows financial markets to speculate on the possible bankruptcy of the States; the absence of rigid solidarity, control or coordination mechanisms which causes the insecurity of the single currency; the inability to implement a crisis exit strategy, which leads several countries to fall and to remain into recession, which weakens further their banking system; the fact that a single interest rate set by the ECB, with arbitrary risk premia added by financial markets, leads to uncontrollable credit conditions in member countries?

Such a banking union would be based on three pillars:

– A Single Supervisory Mechanism (SSM).

– A Single Resolution Mechanism (SRM).

– A European deposit guarantee scheme.

Each of these pillars is subject to specific problems, some related to the complexity of the functioning of the EU (Is banking union limited to the euro area or does it include all EU countries?), others to the crisis situation (should Europe guarantee depositors against the exit of their country from the euro zone? Should Europe support the banks already facing difficulties?), the others linked to the specificity of the EU (Is banking union a step towards more federalism? How to reconcile it with national prerogatives?), the others finally linked to structural choices concerning the functioning of the European banking system (should we control better a European banking system, internationally diversified, integrated to financial markets? Should we refocus banks on their core business, credits and deposits?).

We will analyse the issues and problems of each of these three pillars, and we will then discuss the future model of the banking system in the European banking union.

2. A Single Supervisory Mechanism

The goal of a single European banking supervisor is to have an independent and powerful institution that controls the European banks. The arguments in favour of such a supervisor are the same as for an independent Central Bank. Banks, like money, must escape from the political field to be entrusted to experts. Banking supervision by an independent supranational authority limits the political factors that could impede the follow-up of the objectives and strengthens the credibility of decisions (Rochet, 2008). The independence of the supervisor allows him to assert credibly that all banks will not be saved in the event of bankruptcy, which will encourage banks to reduce their risks. This will reduce the moral hazard of banks which otherwise are encouraged to take risks under the insurance of being bailed out by the State. Independence also ensures the reduction of delays for implementation of the procedures of bankruptcy, delays that are detrimental to the effectiveness of the adopted resolution procedure and create the possibility of lobbying actions limiting the credibility of the overall device. The supervisor should be able to put banks in trouble under supervision before they become a threat to financial sector stability. Speculation on bank failures which feed the crisis, would be greatly reduced. Confidence depends strongly on the quality of supervision. Uncertainties about the quality of the banking sector, on his capitalisation, on the amount of bad debts caused difficulties for banks to refinance themselves on the interbank market.

The European banking supervisor should facilitate the implementation of the common scheme of crisis resolution, by being present both in normal times and in times of crises for the resolution of bankruptcy procedure. Finally, it will monitor the implementation of the new Basel III standards. On 1 January 2014 banks will have to increase the level and quality of their capital: the Core Tier 1 ratio (composed with core equity : common stock and retained earnings) must increase from 2 to 4.5% of Banks' assets, while the TIER 1 ratio must be at least 6%, versus 4% previously.

The single banking supervision should enable to set up both a single mechanism of deposit guarantee and a single mechanism for assistance to banks in difficulty.

The choice of the institution in charge of the SSM has been debated, between the European banking authority (EBA) and the ECB. The EBA, founded in November 2010 to improve the EU banking system supervision, is a young institution. It already ran two series of "stress tests" on banks. The result of *Bankia* for the October 2011 tests reported a 1.3 billion deficit of core capital. Five months later, this deficit was 23 billion; the credibility of the EBA suffered. Moreover, the EBA has no national correspondents; it is based in London, and has authority on the British system while the United Kingdom does not want to take part to the Banking Union.

The ECB lobbied to be entrusted with this task. For instance, the Vice-president of the ECB, Mr Constancio said on 12 June 2012, that "the ECB and the Eurosystem are prepared" to receive these powers; there is therefore no need to create a new institution". Section 127.6 of the Treaty on the functioning of the European Union[1], quoted at the Summit of the euro area of June 29th, makes it possible to give to the ECB supervisory authority.

Financial stability is already an objective of national central banks and they already had a role in the banking sector supervision. In France, for example, the Authority of Prudential Control, which is responsible for the approval and control of banks and of insurance institutions is an independent authority, but it remains backed by the Bank of France.

The Commission estimated that the ECB has an established reputation of political independence. The ECB's good knowledge of the interbank market, of liquidity in circulation, of the situation and the reputation of each bank was an advantage over an independent agency.

So, the European Commission chose the ECB to conduct banking supervision within a single supervisory mechanism (SSM) including the ECB and the existing national prudential authorities (European Commission, 2012 a). The ECB will receive the responsibility of monitoring missions for all the participating member states' credit institutions, regardless of their business model and their size. It will ensure the implementation of standards for the degree of leverage, of liquidity, of own funds and it may, in coordination with the national authorities, impose the constitution of capital buffer or the introduction of corrective measures as deemed necessary. It will be the relevant authority to approve credit institutions. It will ensure the coherent application of the Single Rulebook. In addition to its role as lender of last resort, the ECB would thus be responsible for the supervision of all banks of the banking union, but it will directly supervise banks with assets amounting to more than € 30 billion or at least 20% of GDP of the country where their headquarters are located, as well as those who will ask or receive assistance from the ESM, which represents 200 banks on a total of 6 000 banks in Europe (European Commission, 2013c). It will ensure the control of the supervision of other banks which will be conducted by the national supervisory authorities, who will be accountable to the ECB. The ECB may decide, at any time, to decide to supervise any credit institution. The SSM will benefit from the expertise of national supervisory authorities. The ECB shall have access to all the information available to national supervisors. As the ECB is an EU institution, it will be possible to appeal a decision according to the principles defined in the European treaties.

The new prerogatives of the ECB as a single supervisor will have to take into account the presence of countries outside the euro zone but belonging to the SSM (United-Kingdom, Sweden and Czech Republic will not participate). Non-euro area EU countries are already represented in the ECB within the General Council which brings together all the Governors of central banks of the EU. But currently this Council does not have any power. A fair distribution of powers between euro and non-euro area countries on European banking supervision is going to be very delicate within the ECB, this institution being primarily the Central Bank of euro area countries. So the European Parliament proposes that all participating countries to the SSM are entitled to the same representativeness within the Council who will lead the supervision tasks of the ECB[2].

A Supervisory Board and fully independent services will have to be created within the ECB to avoid conflict with the monetary policy objective. However the Board of Governors will have a right of veto on all decisions. To ensure the democratic legitimacy of the process, the Commission proposes "strong accountability safeguards, notably vis-à-vis the European Parliament and the Council".

[1] Art 127.6 "The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings."

proposes "strong accountability safeguards, notably vis-à-vis the European Parliament and the Council". Concretely, the ECB will have to present to the European Parliament the key points of the supervisory board's minutes and the appointment of the two leaders of the Supervisory Board will have to be approved by the Parliament. The supervisory power of the ECB voted on September the 12th 2013 will be fully effective in September 2014, one year after the entry into force of the texts.
The Commission claims that the ECB will take no mission from EBA whose position in the European monitoring mechanism was specified (European Commission, 2012b): the EBA should elaborate a common legal framework for surveillance through a single Rulebook for banking supervision in Europe, including the countries which would not participate in the Banking Union. It should also provide the texts of laws that will govern the management of banking crises in the euro area. It should ensure regular stress-test on European banks. The EBA may make decisions on the double majority (group of countries subject to the SSM, group of countries not subject to it), which in practice gives a right of veto to the United Kingdom.
The ECB and the EBA are expected to work closely within the European Systemic Risk Board, responsible for alerting the European authorities about the risks of banking and financial instability in Europe. It is not yet certain that this committee will have an effective role, in the absence of an established doctrine and a strong will.

Delicate transfers of sovereignty for a single supervision

The risk is great that entrusting these issues to the ECB is a new step towards the de-politicisation of Europe. Certainly, the European authorities claim that the ECB will be subject to enhanced transparency and democratic accountability requirements. Although the President of the ECB often speaks before the European Parliament, the Parliament control remains formal; the ECB keeps a full independence vis-à-vis national governments and European institutions. Although a Monitoring Committee is created, the Governing Council will keep the responsibility for the decisions in terms of banking supervision and monetary policy. Despite the creation of a unique supervisory mechanism including national authorities, the ECB will make decisions in full independence, and simply has to "account for" and "reply to parliamentary questions" but these decisions will not be questionable, as is the case today for monetary policy decisions.

Will the ECB be able to account for the diversity of the European banks? The European Parliament says that it will be one of its duties but it does not explain the practices that will protect the diversity of financial institutions (Committee on Economic and Monetary Affairs, European Parliament, 2012). The Single Rulebook on which the EBA works and which must serve as a code of conduct for the ECB advocates a uniform regulation of the whole of European banks. However, should the governance, the ratio of capital of a small German retail bank or a French savings bank be the same as those of a large European banking group?

One should have considered a dual system: the ECB would manage large transnational banks and national regulators would supervise national and regional banks and would preserve their specificities. However, national regulators are facing today unequal risks: they are facing much bigger risks in Southern countries (Greece, Spain, and Portugal) than in Germany or Finland. A dual system would have risked accelerating the withdrawal of deposits from medium size banks of Southern countries.

The main point is the objective for the European banking system: large transnational banks, with cross-border deposits or credits? National banks of reduced sizes, well inserted into the economic, local or national, structure?

Banks are encouraged to diversify internationally to reduce their risk. But the crisis showed the dangers of diversification when banks are venturing into foreign markets that are unfamiliar. Banks lose contact with domestic firms, which degrade the quality of credit. Local authorities would no longer have dedicated banks.

The implementation of the guidelines of this new authority may be problematic. A banking group in difficulty may be requested to sell its shares of large national groups. But will national governments agree to expose a national champion to a foreign control?

Governments will lose their ability to influence the distribution of credit by banks, which, for many people, is desirable (no political influence on credit supply), but is dangerous in our opinion: governments will lose an industrial policy tool that could be used to finance SMEs, medium size firms, or to promote the ecological transition.

For instance, in the case of the Dexia bank, the opposition between on the one hand the European Commission and on the other hand France, Belgium and Luxembourg, has for a long time blocked the plan to dismantle the bank. This plan includes the resumption of financing activities of local French authorities of Dexia by a public bank, created by the cooperation between the *Caisse des dépôts* and the *Banque Postale*. On fair competition grounds, Brussels questioned the financing of local authorities by such a bank because Dexia received public aid for its dismantling plan. This threatens the continuity of the financing of local French authorities, could block their projects and especially forbid France to provide specific and secure mechanisms to finance local projects by local savings.

Similarly, in October 2012, the French Government rescued the BPF, *Banque PSA Finance,* the Bank financing PSA, the Peugeot group, in order to avoid that PSA can no longer provide credit to its customers. France guaranteed 7 billion bonds of PSA and got a commitment of the creditor banks of the BPF to increase their loans. Is this compatible with the Banking Union?

Finally, the French project of a public investment bank (*Banque publique d'investissement*, BPI) raises issues in this context. This Bank should provide credit according to specific criteria, linked with the French industrial policy, different from those of the profession. The question of the compatibility of such a public institution with the Banking Union will arise.

European banks will have to evolve in different national regulations about interest income taxations or special deposits or financing circuit. Is this compatible with the Banking Union or does the convergence be organised? And who will decide it?

In any case, the SSM does not address the question of how to ensure similar credit conditions in different countries, with the same currency but different economic situation. In the recent past, equal nominal interest rates encouraged rising debt in countries with strong growth and inflation. Today, interest rates are strongly influenced by risk premia imposed by markets.

One can certainly imagine that the ECB practice diversified macroprudential policies imposing stronger capital ratios to banks in countries in expansion and lower ratios for countries in difficulty. But this raises three questions: macro-prudential logic will go in the opposite direction of the micro-prudential one; this implies that banks remain national; the strategy of the ECB is likely to go in the opposite direction of the economic and fiscal strategy of the MS. Will the ECB punish a country having too expansionary policy according to the Bank views by imposing strong capital ratios to its banks?

A European control presupposes a common vision on the banking system regulation. An agreement needs to be reached on crucial questions such as: is it necessary to separate retail banks from investment banks? Should banks be prevented to intervene on financial markets for their own profit? Do we need to promote the development of public, mutual, or regional banks or on the contrary the development of internationalised banks? Should we encourage banks to give credit primarily to households, businesses and governments of their countries of origin or on the contrary to diversify? Will macro-prudential rules be national or European? In each of these issues, the MS, the Commission, the ECB, and the EBA can have different points of view: who will decide?

Of course, in theory, it would be easier and more legitimate to rescue banks under a single supervision. But this prospect is hardly useful in the current crisis, where the problem is to help banking systems already in trouble in Spain, Cyprus, Ireland, or Slovenia.

Southern countries' current difficulties condemn the entire euro area to a complete centralization of banking regulation, whose defaults will appear in a few years. To us, the risk seems important that euro zone countries agree in emergency to enter a dangerous path, and that the banking union is as little analysed *ex-ante* as was the case with the single currency, the SGP, the fiscal Treaty.

The Cypriot crisis has highlighted the difficulties of a European supervision. The European banking system is currently highly heterogeneous. The banks' balance-sheet-to-GDP ratios differ strongly among countries (table 1). In some countries, banks have a significant share of deposits from non-residents. Does the SSM need to make national systems converge or can it accommodate their diversity?

The risk is that the banking union leads to conflicting situations between national strategies on banking and financial matters and the ECB, either because some countries may wish to keep certain public or regional features in their banking system, or because some others will want to maintain they predatory feature (to attract foreign deposits). Economic issues will also arise: will governments still have the responsibility and the ability to vary credit policy either according to the real estate market situation, or to the macroeconomic situation?

Table 1. Banks' consolidated balance sheets-to-GDP ratios in 2012, in %

Luxembourg	**218.5**
Malta	7.9
Cyprus, Ireland	7.1
United Kingdom	5.0
Netherlands	4.1
France	4.0
Spain, Portugal	3.4
Germany, Austria, Finland	3.1
Belgium	2.8
Sweden	2.7
Italy	2.5
Slovenia	1.5
Estonia	1.2
Slovakia	0.8

Box 1. Banking regulation in the United States

In the US, banking supervision is dual: it adapts to the two types of US banks: national banks (intervening at the federal level) and State banks (specific to each State). Supervision is carried out by the Fed and the FDIC. The Federal Reserve membership is mandatory for national banks and optional for State banks. In the event of joining, banks must subscribe to their regional reserve Bank and deposit the corresponding reserves. The Fed regulates and supervises the banks which are members of the Federal Reserve and the Bank Holding Companies system (12% of commercial banks and through the BHC 96% of commercial banks' assets). It sets the level of mandatory reserves. The FDIC is responsible for the supervision of State banks that are not members of the federal reserve system. It is also responsible for Bank bankruptcy procedures resolutions and ensures the continuum of prudential policy and resolutions procedures.

3. A single resolution mechanism (SRM)

Until now, within the European Union, the legal provisions governing bank failures were country-specific. In some countries, like the UK, banks are submitted to the general code of firms bankruptcy and thus to a judicial procedure. Other countries, such as France have mixed regimes: an administrative procedure conducted by the banks' supervisor coexists with a judicial procedure.

Since June 2012, the European Commission propose to establish single resolution mechanism (SRM). This SSM will be based on a Bank Recovery and Resolution and Directive (BRRD), agreed by the Council in June 2013, but not yet voted by the EP. The scheme has four pillars. The first one is to improve prevention by requiring banks to put in place *wills*, i.e. to provide strategies for recovery, or even for dismantling, in case of crisis. The second gives to the European banking authorities the power to intervene to implement recovery plans and to change bank managers if the bank does not meet the capital requirement. The third indicates that, if a bank fails, national authorities will be able to take control of it and use instruments of resolution such as the transfer of activities, the creation of a defeasance bank (a «bad bank») or the bail-in. "The bail-in tool will give resolution authorities the power to write down the claims of unsecured creditors of a failing institution and to convert debt claims to equity….. In the event of a bank failure, shareholders will be affected first, then subordinated claims and, if necessary, claims of higher categories. These claims could be transferred in equity. Some liabilities are permanently protected deposits below 100 000 euros, liabilities to employees, inter-bank liabilities with a less than seven days maturity. Others (deposits from natural and SME) persons could have a specific treatment. National resolution authorities could also exclude liabilities to avoid contagion or value destruction in some creditors. The four requires than MS set up a resolution funds, which must reach, within 10 years, 0.8% of the covered deposits of all credit institutions, which would have to finance it. The funds would provide temporary support to institutions under resolution. The problem is that the sharing of losses between ordinary creditors, privileged creditors and the resolution fund remains uncertain.According to the fifth, member States shall ensure that the institutions maintain, at all times, a sufficient aggregate amount of own funds and eligible liabilities expressed as a percentage of the total liabilities of the institution (European Commission, 2012) to absorb losses. This percentage is estimated to be at least 10% but will be fixed in 2016 after a recommendation by the EBA. So, in principle, taxpayers would not have pay for the creditors of insolvent banks. The EBA will have to set out the legislative framework for these instruments of resolution. The administrative body responsible for the resolution at the national level is left to the discretion of each country: Central Bank, finance ministry or a specific institution.

On 10 July 2013, the Commission proposed to go further in the SRM centralization (European Commission, 2013,b). The ECB would signal banks in difficulty to a Single Resolution Board, SRB, consisting in representatives from the ECB, the Commission and the supervisory authorities of the relevant country). The SRB would propose a resolution procedure, which would be formally decided by the Commission (as the SRB has no constitutional existence) and implemented by the relevant country under the SRB control. Should a national resolution authority not comply with one the decision of the Board, the latter could address executive orders to the bank in trouble. National resolution funds would be replaced by a Single Bank Resolution Fund. The European Council hopes to reach an agreement about this mechanism by the end of 2013 but giving those new powers to the Commission may require a new treaty.

After an appropriate “burden-sharing” by private investors, Banks may benefit, for their recapitalisation, from funds from the European Stability Mechanism (ESM), set up on October 8 2012. The ESM will borrow on financial markets at low rates (it aims to be AAA rated) and will be able to provide financial assistance to the European countries in difficulty through a European assistance under a *Memorandum of Understanding*. It will buy public debt on primary and secondary markets and will thus contribute to lower interest rates. It will be able to mobilize €700Md with €80Md effectively paid-up capital, the rest being available if needed. According to the Treaty establishing the ESM, It will have a status of senior creditor for public debts. When the European supervisor will be in place, the ESM will have the possibility to directly recapitalise euro zone banks in difficulty (and, in this case, it will intervene without the senior creditor status).

Here also, this leaves entire the question of his possible intervention for banks currently in difficulty. One must choose between two strategies: the ESM benefit banks having been subjected to the SSM, which means that the ESM will only intervene in the next crisis; the ESM rescues banks currently in difficulty due to the financial and economic crisis, which means that the ESM will quickly play a central role.

If this mechanism works effectively, if the ESM supports, recapitalises and restructures all European banks in difficulty, it would be shareholder in a large number of banks. This would raise the question of the management of such participations. Is it the role of the ESM?

The system put in place remains complicated with the intervention of the ECB (via the SSM), of the ESM, of the national authorities of resolution and possibly of the deposit guarantee fund.

Box 2. Banking crisis prevention and resolution in the United States

This European crisis resolution scheme belongs to early corrective action policies which already exist in other countries. In the United States, following the crisis of banks and savings banks during the eighties, the Federal Deposit Insurance Corporation Improvement Act was adopted in 1991. This text establishes a resolution framework structured in two pillars: early corrective action and resolution at low cost. The first pillar is an "institutional response to the problem of capture of the regulator by the regulated" (Scialom, 2006): its objective is to decrease the regulators waiting propensity. Banking supervision and monitoring are done through two tools: on-site inspections and reporting obligations. The FDICIA determines the actions of the regulator and banks on the basis of their capital ratios. When banks fall below established in advance levels of funds, pre-defined corrective measures are applied. These measures are: the suspension of bonuses and dividends, a plan for the recovery of own resources, the obligation to recapitalise, the restriction of deposits remuneration, the limitation of the payment of the executives’ compensation, a placing under administration or the liquidation if the bank fails its recapitalisation, the suspension of subordinated debt payments. The FDIC may decide the bank liquidation if it remained more than 90 days below the 'critical undercapitalization’ level.

The codification of the sanctions makes predictable the choice of regulator and prevents arrangements between the bank and its regulator. The second pillar means that the method of resolution chosen for a bank in difficulty shall be the one which minimizes the cost of the liquidation for FDIC.

A not-yet credible crisis resolution scheme

According to Finance watch (2013), it is not sure that these dispositions could avoid a full tax-payer protection, if banks would remain interconnected and too-big. If a systemic bank is in financial difficulty, it would be difficult to report the losses on other credit institutions, without creating a contagion effect. The scheme would require first to reduce the banks sizes and to separate financial and market activities from credit activities.

A perverse effect of the projected crises resolution scheme is that the potential involvement of shareholders and subordinated creditors would make banks' shares and claims much riskier. Banks' reluctance towards the interbank credit and the drying up of the interbank market will persist; banks will find it difficult to issue securities and will have to increase their remuneration. Banks will be subject to financial markets' appreciation. However, Basel III standards require banks to link their credit distribution to their own funds. The risk is that banks will be weakened and that credit supply will be reduced, contributing to maintain the zone in recession.

Aglietta and Brand (2013) clearly approve of shareholders' involvement: "the best established principle of the market economy is that it cannot function properly if the threat of bankruptcy is not effective for all private agents." But are banks private agents like any other agent? Should not we separate clearly banks between banks playing a quasi-public role (management of deposits, loans to households, enterprises, public authorities) and banks with financial market activities?

The SRM project deprives the national authorities from all powers. They would be obliged to obey to the Single Resolution Board instructions. The losses of a bank would be supported by all countries belonging to the banking union, thereby justifying a single control. According to the project, the Commission and the SRB would be able to decide to impose a resolution plan to a bank, without the agreement of the relevant governments. It is an important step toward European Federalism, which was not yet accepted by the Germany, for instance, who claimed for more political union though a constitutional reform before this hidden step.

Following the decisions of the 29 June 2012 Summit, Spain could be the first country where banks would be directly recapitalised by the ESM. However, this would not occur before 2014; the modalities of such a procedure and the impact of the ESM support on the governance of recapitalised banks has still to be specified. As shown in the case of Dexia, the terms of a bank restructuring can have serious consequences for the countries where it was operating. Are governments (and citizens) willing to lose all power in this area?

The assistance to Spain agreed in summer 2012 foreshadows what could the European procedure for banking failure resolution be. On 25 June 2012, the Spanish government requested assistance from Europe to restructure and recapitalise its banking sector. The 29 June 2012 Summit agreed to that request and entrusted this task to the ESM. The required conditions have been specified in a *Memorandum* agreed by the European Council. The document points out the weaknesses of the Spanish economy: growth boosted by strong households' and firms' borrowing, persistent external imbalances, a banking sector weakened by the burst of the financial bubble in 2007, which faces very high interest rates on the interbank market and implements credit rationing. The EU assistance is designed to clean up balance sheets of Spanish banks, which have a large amount of bad debts, to restore credit supply by allowing the return of Spanish banks on the interbank market and to improve financial sector's transparency.

The assistance programme has three steps: the detailed identification of the situation and of the needs of banks; their recapitalisation and restructuring ; the withdrawal of their bad debt in a *bad-bank*, created for this purpose (the AMC: *Asset Management Company*). But the aid is awarded according to two sets of conditions, the first one concerning banks, the second one Spanish governance. Based on the results of *stress tests*, banks must offer recapitalization plans that will be evaluated by the Spanish authorities, the EBA, the ECB, the IMF and the European Commission. Banks must achieve an equity ratio of 9% in December 2012. The Commission, the EBA and the ECB can examine the banks having received European aid and may choose to liquidate an institution if they consider it to be too fragile. The independence of the Central Bank of Spain and its supervisory power should be strengthened. The Spanish authorities must encourage disintermediation and financing *through* markets. Finally, the Spanish Government must reduce public and external deficits and undertake the structural reforms recommended in the context of the European semester.

The aid was spread into two parts: a first part, a EUR 39.5 billion loan with an average maturity of 12.5 years has been agreed in December 2012 by the Eurogroup and the ESM to support the most vulnerable banks. All Spanish banks have run *stress tests* that assessed their recapitalization needs; their results were published in September. Banks were then classified into four groups. The most solid (without recapitalisation need) will be in group 0; Banco Santander, BBVA, La Caixa, Sabadell, Kutxabank, Bankinter and Unicaja are part of this group according to the report of Oliver Wyman's firm. The four banks already nationalized by the Fund for Orderly Bank Restructuring (FROB) are classified in Group 1. Other Spanish banks are either in Group 2 (for those who are unable to recapitalize on their own) or in Group 3 (for those who obtain a delay until June 2013 to raise capital by themselves). Banco Popular, MNB and the merged group between Ibercaja, Liberbank and Caja 3 received a delay until 2014 to recapitalize while Catalunya Banco, NGC Banco, Banco de Valencia and Bankia must present a restructuring plan and transfer their unsafe assets to the bad bank, the Sareb. This institution, created on 1 December 2012, will be able to buy assets up to 90 billion euros. According to Fernando Restoy, the FROB president, discounts applied to the loans transferred to the *bad bank* will be 45.5% on average and discounts applied to real estate assets will reach 63 % (see Birambaux, 2012). Junior and hybrid debts will be converted into equity or will be redeemed with a high discount.

Spanish banks received the second part of 1.9 billion euros for the recapitalization of the second group of banks in difficulty. The Commission report in March 2013 (see, European Commission, 2013) is optimistic about the recovery of the sector and does not expect other recapitalizations for the moment.

This ambitious assistance plan has not received full investors' confidence: Spanish banks soundness is tested via *stress tests*. However these *stress tests* had failed in 2011 to foresee Bankia's difficulties: are they really able this time to assess the needs of Spanish banks? Besides, this project monitoring is extremely complex. In the absence of a European supervisor, Spanish public authorities are responsible for the resolution: they are supported by the FROB, the public fund created in 2010 to reform the banking sector. The European Commission, the ECB, the EBA and the IMF monitor the proper conduct of the proceedings and may intervene on site. The difficulty of coordination of such an organisation diminishes the credibility of the project. The drastic recapitalisation that Spanish banks will have to perform may decrease credit availability, which will accelerate the decline of the Spanish economy. Spain has benefited from a substantial drop in the interest rate it has to pay: from

6.5% in summer 2012 to 4.3% in April 2013, but Spanish GDP decreased throughout 2012 and is expected to continue to fall in 2013.

In order to clean up the bases of the future European banking union, the European banking crisis management could extend to all European banks balance sheets the withdrawal of bad loans to an *Asset Management Company*. Since 2008, the United States has implemented such a measure through their TARP: *Troubled Asset Relief Program,* which was intended to clean the financial sector from its toxic assets. To strengthen financial institutions and banks own funds, the US Treasury also purchased preferred shares for $ 205 billion in the benefit of 707 companies. On the whole $ 389 billion were mobilized for this project; banks and other beneficiaries have currently refunded 80% of this amount.

Note that the *Bad bank* strategy has its dangers. In 1995, the Credit Lyonnais, owned by the State, was split into a healthy entity pursuing the bank activity and a bad bank responsible to sell all non-performing assets and activities of the Credit Lyonnais (Blic, 2000). However the concentration of assets within this bad bank generated a global devaluation of the value of the transferred assets, whose sale constituted an additional cost for taxpayers.

The Cypriot crisis led to the first implementation of the new method of banking crises resolution. European institutions refused to go beyond an aid of € 10 billion to Cyprus, considering that this would have induced an unsustainable debt. They refused to help directly a banking system they judge oversized for the country, badly managed, specialized in money laundering and securing dubious Russian assets. Thus, the new method has been implemented: deposits are guaranteed up to € 100,000 (after an initial version of the plan, which awkwardly planned to tax deposits under this level). Shareholders and creditors of Laiki, the second bank of Cyprus, which will be closed down, lose everything. The amount of less than € 100 000 deposits will be transferred to the Bank of Cyprus. The amount of deposits in excess of € 100 000 is frozen and will be refunded according to the results of the Bank's assets liquidation (losses are estimated to be of 60%). Debts and deposits over € 100,000 at the Bank of Cyprus, which is restructured, are frozen and will be partly converted into shares to recapitalize the Bank (in application of the bail-in principle); their losses should amount to 40%.

However, this implementation of the new European scheme of crisis resolution revealed weaknesses: banks have faced huge withdrawals from depositors and were forced to close for several days. Capital flows controls had to be introduced when banks reopened. Frozen assets and losses for large deposits have affected SMEs and some households doing real estate transaction, having just received an inheritance or saving for their retirement. Above all, Jeroen Dijsselbloem, the Eurogroup President, who said that the model applied in Cyprus corresponded to the future practice of the banking union, had to step back and pretend that the case of Cyprus was unique. The Eurogroup and several leaders of the ECB made similar statements, in complete contradiction with on-going projects, thus weakening the choice of bail-in as the method of resolution.

4. The European deposit guarantee scheme

The banking union should include a European deposit guarantee scheme. A deposit guarantee system protects savers in case of bank failure by refunding their deposits up to a certain ceiling. It is one of the sovereign tasks of the State to provide citizens with a risk free instrument of payment and saving. Customers do not precisely know the financial health of their bank; most depositors, with deposits not exceeding a certain amount, cannot be asked to be interested in that; they are subject to asymmetries of information which, in normal times, promotes confidence in credit institutions. On the other hand, in a banking crisis, asymmetries of information between depositors and towards banks strengthen the contagion of panic and cause a rush of investors seeking to withdraw their deposits massively. Then liquidity crises turn into solvency crises threatening to contaminate the entire banking system. A bank failure deteriorates stakeholders' confidence on the interbank market and decreases credit supply; therefore, it has a negative impact on the real economy halting activities that depend on these credits and causing a sudden stop of investments. A deposit guarantee helps avoiding bank runs.

However, it is necessary to distinguish between relatively small deposit amounts, with interest rates incorporating no risk premium, which must be guaranteed and other deposits, with interest rates incorporating risk premia for, deposits that should rightfully bear the risk of losses.

The harmonisation of the deposit guarantee level in Europe would avoid that some countries attract deposits from their neighbours by offering a full guarantee of deposits, a strategy implemented by Ireland during the crisis, knowing that this full guarantee may have heavy consequences for the population of the country concerned. On the other hand, given the differences in standard of living, the share of guaranteed deposits would widely differ from one country to another.

There are currently 40 different deposit guarantee regimes in the 27 EU countries (European Commission, 2010). Depending on countries, these schemes are managed by the government, by banks or by both. A group of banks may decide to create a common private fund to guarantee their deposits according to specific rules of their choice. EU lawmakers have developed the deposit guarantee *via* several directives: in 1994 [Directive 94/19/CE, 1994] a first legislative text set a minimum level of guarantee corresponding to 20,000 EUR per depositor; it requires that each MS sets up officially a guarantee fund and that all credit institutions subscribe to a guarantee scheme. The minimum level of guarantee was raised to 50,000 EUR in 2009 and 100,000 EUR on 31 December 2010 [Directive 2009/14/CE].

In 2010, the European Commission put forward the idea of a pan-European deposit guarantee system by 2014 [European Commission, 2010]. It called for a networking of existing systems by proposing the establishment of a mutual borrowing facility between all funds and a gradual harmonisation of procedures. But the terms of the harmonisation of the systems divided the European Parliament and the Council. The Member States want to reduce the financing rate of the funds paid by banks, while MEPs want to make risky banks contribute more significantly *via* a system of risk premium. The proposition was not yet adopted.

Under the assumption of a 100,000 EUR guaranteed ceiling, the amount of covered deposits would be 6,655bn EUR (JRC Report, 2010). Compared to 2007 when regulations in Europe requested a guarantee of 20,000 EUR only, the amount of guaranteed deposits would be increased by 18% (+ 994 billion euros) and the number of fully guaranteed deposits by 8% (+ 3 million deposits) but, in the event of a funding *through* a levy of a certain percentage of eligible deposits paid by banks, it would cost banks 815 million EUR per year for 10 years on average in the EU which corresponds to a decrease by 4% in their annual profit for 10 years as compared to 2007.

The crisis has shown the contradiction between the more and more internationalized structure of European banks and the deposit guarantee which remained at the national level. The problem appeared particularly acute for countries like Ireland or Cyprus where banking systems were oversized. This can be prevented in two ways: settling the deposit guarantee at the European level or, on the contrary, setting limits to the size of each country's banking sector, which would have enabled to prevent credit bubbles and the accumulation of cross-border deposits, source of instability. The first solution is preferred in Europe today. But the Cypriot crisis is perhaps going to reopen the debate.

The Spanish banking crisis recalled the need to protect public finances in the event of bank failure, and the Commission wishes to launch discussions on the establishment of a pan-European guarantee scheme as soon as the 2010 directive is passed in Parliament. The Deposit Guarantee Schemes should reach 0.5% of the covered deposits in 2017. This scheme could be financed by a contribution from the guaranteed European banks. However, in 2013, two issues remain problematic. According to Gros and Schoenmaker (2012), a banking union must be created under a "veil of ignorance", i.e. not knowing which country presents more risks: this is not the case in Europe today. It is necessary for the Scheme to guarantee all European banks because if it covers initially only the strongest large transnational banks, depositors will rush to guaranteed banks and this would immediately increase the risk of a euro zone break-up.

The European Commission has not chosen between a uniform rate of contribution to the guarantee scheme and a variable rate depending on the risk level of guaranteed institutions. The majority of countries have a uniform assessment system, but Canada and France have a variable risk pricing, which tends to reduce banks’ moral hazard.

Box 3. The bank deposits guarantee in the United States

In the US, the deposit guarantee is provided by the Federal Deposit Insurance Corporation (FDIC), an independent federal agency created in 1933 by the Glass Steagall Act, whose managers are appointed by the President of the US and by the Senate. The FDIC mission is to maintain public confidence in the US financial system. Almost all US banks are affiliated with the FDIC even if membership is required only for the bigger ones. UCITS and other collective funds are not insured. Deposits are covered up to an individual amount of $ 100,000. The FDIC guarantees more than half of the total amount of deposits in the US. It also intervenes to limit bank failures: it inspects and controls directly more than 53,000 banks, of which more than half are in the US. It has means of resolutions of failures; the most common means is the sale of deposits and credits to another institution. The FDIC resources come from premiums by banking institutions and insured savings, and from the certificates of association signed by the members at their membership and from earnings on investment in US Treasury bills. Since 1993, the premium of credit institutions is based on their risk level (Morel and Nakamura, 2000): with capital ratios (Cooke and Tier l ratios) and a rating (determined according to five criteria: asset-liability management, asset quality, management quality, results and liquidity), the FDIC sets the institution's premium. Thus, until late 1995, the premium of institutions to the guarantee fund varied between 0.09% and 0.49% of deposits as determined by the FDIC on the risks of each institution. In the 2010-2011 period, 249 banks have gone bankrupt in the US, which has divided by three the reserve for possible loss of the guarantee (from 17.7 billion to 6.5 billion) Fund. The current reserve fund represents 0.17% of covered deposits. The FDIC plans to return to its long-term target, a reserve of 1.35% of deposits covered by 2018 (FDIC, 2012).

A European deposit guarantee scheme difficult to settle

The European Commission has worked for several years on the networking of European Union banking schemes. With the banking union project being focused on the euro area, the area of implementation of the guarantee fund remains undetermined; the harmonisation of existing systems is tricky. If the fund is rapidly put in place, it will run the risk of having to deal with the difficulties of Southern Europe countries, Germany or Finland possibly refusing to contribute to this fund which could increase wealth transfers between Northern and Southern Europe. Current projects do not specify if the fund will be financed by contributions of banks *ex ante* or if it will be based on a guarantee of the states and a refund of banks *ex post*.

Schoenmaker and Gros (2012) propose that the European guarantee fund owns a permanent reserve representing 1.5% of covered deposits (i.e. nearly EUR 140 billion). But this would only allow to save one or two major European banks. The credibility of such a fund in the event of a bank crisis and contagion risk is therefore limited. The fund permanent reserves are inevitably small as compared to the amount of deposits which need to be reimbursed in the event of a crisis. Only a fund supported by a monetary authority can offer a full and credible guarantee in the event of systemic crisis. Even if the fund can raise contributions *ex ante* from the banks in order to be able to intervene in the event of limited problems, the deposit guarantee will continue to depend as a last resort on the States, on the ESM and on the ECB, these being requested to intervene, in the short term, in turn depending on the severity of the problem. The guarantee must be unlimited, but the German Constitution (and political opinion) opposes such a guarantee. Banks' contribution might intervene *ex post* to restore the level of the guarantee fund and possibly repay the first in line creditor. The difficult point remains to determine who pays for the guarantee as a last resort, between banks and the States, between the country and the whole EU countries covered by the agreement. Does this mean that the Banking Union necessarily require setting up a federal Treasury with a European tax (Aglietta and Brand, 2013)? This is probably excessive.

The authority in charge of the fund is not yet settled. The ECB will supervise the banking system, but it is much more difficult to dedicate the management of the deposit guarantee scheme to the ECB. According to Repullo (2000), the deposit guarantee must be separate from the function of lender of last resort. Otherwise, the ECB could excessively use its money creation ability to recapitalise banks. The monetary policy targets and support to banks could be in conflict. Therefore a deposit guarantee and crises resolution authority should be created. It should be separate from the ECB, which would necessarily have a right to look at banks behaviour, and would come in addition to the one of the EBA, of the ECB and of national regulators. On the other hand, the ECB would continue to play its role of lender of last resort. This is implemented by the French banking reform in 2013. The viability of such a complicated system is unclear. We think that it should be stated that the ECB will intervene, if necessary, to guarantee deposits in a situation where States or the ESM could not do so, but that this intervention will only consist in a loan from the ECB to the bank guarantee fund or to States, which they will have to repay.

From 1979 to 2000, in France deposits were insured by the so-called "*solidarité de place*" mechanism (financial centre solidarity). In a crisis situation, the Governor of the Bank of France could "organize the participation of all credit institutions to take the measures necessary for the protection of the interests of depositors and third parties, for the proper functioning of the banking system as well as for the preservation of the reputation of the place " (Marini, 1999) This mechanism was only implemented on one occasion, the bankruptcy of the Al Saudi Bank in 1988. In case of a crisis the risk of a depositors panic pushes banks to show solidarity and coordinate themselves to avoid an implementation of this solidarity. Following the introduction in 2000 of a deposits guarantee fund, the French Government chose to no longer mention this solidarity of the banking community, considering that the fund organised a permanent solidarity. The advantage of the *solidarité de place* is that it is not necessary to immobilise funds. Moreover the guarantee is *a priori* without limit and the bank in difficulty could be taken over by another bank, which could have an interest in this operation since it would thus regain customers and some market shares. But this system only worked for problems in small banks.

As the risk of a euro zone exit of a MS has not entirely vanished in 2013, the question is: what guarantee would be provided by the banking union for euro denominated deposits in case of a conversion into national currency? A European guarantee on deposits in euros is needed to prevent the capital flight away from countries believed to be likely to leave the euro area. But in the current situation, given the risk that such a guarantee would have to work for some countries (Cyprus, Greece, Portugal or even Spain), it is difficult to implement it as the Northern countries refuse to grant that guarantee.

The Cypriot crisis has shown that the common deposit guarantee is not easy to implement as long as the banks' balance sheets are not effectively cleaned up, as long as concerns on possible bank failures remain and as long as banking systems in Europe are not under control. The common guarantee can only be the last phase of the banking union.

The crisis also showed the limits of the € 100,000 ceiling. Liquid assets of some SMEs, funds of households waiting for being re-allocated, etc. have been affected. Euro zone countries must choose between two strategies: offer all depositors the possibility to have a saving instrument perfectly guaranteed (at least in national currency), with no ceiling, but with limited remuneration; or leave depositors choose their bank, knowing that having funds in some banks implies some risks which are difficult to assess.

Finally, the European institutions made shareholders, creditors and large depositors of banks in difficulty pay for the deposit guarantee by aggregating the cost of this guarantee for the two banks in question, which means that the European guarantee fund will have only a decorative role.

5. What model for the euro area banking system?

There is no single banking system in the euro area today, but the juxtaposition of 15 national markets strongly divided by legal, economic, social, historical and tax barriers. With the exception of the Benelux countries, foreign banks represent no more than 10% of credits in each national market. There is a European interbank market and a competitive market for very large firms financing but retail banking remains national. Entering a domestic market goes through taking over existing entities. Until now, cross-border movements in own funds have been rare and of limited size.

A full banking union would involve direct competition of all banks in the euro area, on a unified basis. This implies to cut the links between the borrowers of a country (government, local authorities, firms and households) and national banks. This implies that the capacity of a bank to make loans depends above all on their solvency, their own funds and financial markets' assessment, at the risk of blindness periods and excessive mistrust periods, which are usual in this field.

One could prefer the opposite strategy: a restructuring of the banking sector, where a large number of retail banks would be isolated from financial markets, should focus on their core business (credit to local agents, based on a detailed expertise, to the firms, households and local authorities of their countries). Their solvency would be guaranteed first by the prohibition of risky or speculative operations, then by the State, whose debt would be guaranteed by the Central Bank. Certainly, a bank could be in trouble if its country is in a depression and if companies or households have difficulty in repaying their debt, but the State may come to his rescue, especially as the credits supplied by the bank fit into the economic strategy of its country.

Will the banking union impose the separation of retail and investment banks? Will it prevent banks whose deposits are guaranteed to intervene in the financial markets for their own account? Will it be a new step towards banks financialisation or will it mark a return to the Rhineland model?

5.1. The universal bank model in Europe

The crisis has questioned the universal bank model where deposits finance and guarantee market activities. It is necessary to choose between two models: the universal bank or the return to banking specialisation.

On the other hand the crisis has shown the fragility of specialised institutions which had an insufficient deposit base and depended heavily on markets for refinancing. Banks which in normal times used strong leverage effects to achieve high profitability levels suffered particularly. After *Lehman Brothers* failure*,* banks such as *Goldman Sachs* or *Morgan Stanley* abandoned the Investment Bank model, affiliated to the Fed, strengthened their own funds, and can now collect deposits.

The European move towards universal banks has resulted in major structural changes. The rise in "non-banking" institutions such as insurance or pension funds (the institutional investors) has been at the expense of the banks which had reacted by operating more and more on financial markets, for their own account or as intermediates. The banking sector's connection with the financial sector increases the contagion phenomena and the spreading out of the financial crisis to the real economy. According to Paulet (2000), there is an empirical link between the growing market share of institutional investors and banking fragility, the former strengthening the latter.

The universal bank model, which combines the different banking activities, has shown better resilience during the financial crisis. The heavy losses of markets and investment banks activities have been offset by their retail bank activities. However, these losses have reduced banks' own funds. This link between banking activities destabilises retail banking activity which is essential to the financing of the economy. It has also contributed to the development of suspicion and concern on the strength and stability of the European banking system. Applying "fair value" accounting to the whole banks' balance sheet facilitates the propagation of the crisis: market fluctuations are transmitted to credit supply even if they should obey different logics. Accounting rules should not be similar for so different activities: short-term for market activity and long term for credit supply. The universal bank balance sheet is thus structurally opaque and fragile.

A better regulation of the EU banking system requires the separation within banks of activities with different logics, procedures and risks (Pollin, 2009). The financial crisis has affected the core functions of banks (their capacity to supply credit and to manage means of payments), making it a serious crisis for the real economy. As during the 1929 crisis, the real economy financing has been interrupted. Banking regulation must be sought to avoid the occurrence of such a crisis.

5.2. Should we return to the Glass-Steagall Act?

As soon as in June 2009, the Obama administration published a draft for a financial markets reform, *the White Paper on Financial Regulatory Reform*. The United States in 2010, and the United Kingdom in 2012, have planned to implement a separation between investment and retail banking activities.

The July 2011 US reform of the financial sector (*Dodd-Frank Wall Street Reform and Consumer Protection Act*) introduces the "Volcker Rule" designed to avoid banks speculates against their clients. It prohibits banks protected by the FDIC deposit guarantee to run trading activities for their own account (proprietary trading) and to own participation in investment funds (hedge funds, private equity). These activities should be confined to a specific structure. Subscriptions to investments funds may not amount to more than 3% of the own funds of the banks. Banks can hold more than 3% of the capital of these funds. But the activities of market-maker and hedging may remain in the bank. The rule should apply from July 2017.

In the United Kingdom, the Vickers report should be implemented in 2019. Traditional banking activities (deposits and loans to households and SMEs) will be confined in a specific structure isolated from markets and investment activities. Transactions on derivatives, market-making and market interventions will no longer be made in the same bank as retail activities. However, the classical bank could engage in some markets activities requested by customers (exchange rate or interest rate risks hedging). Retail banking should have independent governance and be separate legally, in the form of a subsidiary for example.

In Europe, the Liikanen report (Liikanen, 2012) proposed to separate risky financial activities from traditional banking activities by splitting banks into two separate entities. It contains five proposals:

– The own account and financial activities should be included in a separate legal entity. Activities for own account, positions on assets or derivatives resulting from markets activities, unsecured loans to hedge funds, structured investment vehicles (SIV), investments in capital-risk, should be separate. This would apply only if assets exceed a certain level of the bank balance sheet (in % of assets or in volume). However, the classical bank could engage in some markets activities requested by customers (interest and exchange rate risks hedging). The financial institution will not be able to be financed by guaranteed deposits. However, the report does not advocate the introduction of two types of banks so that retail banks can provide financial services to their customers. The two banks will be allowed to be in a common holding, but they will have separate capitalisations.

– Banks must develop banking crises resolution plans controlled by the EBA.

– Banks must have a large amount of own funds and junior debt (which can absorb losses). Banks' managers will have to hold junior debt.

– Own funds requirements should be strengthened, accounting better for the risk, particularly for market activities and real estate loans.

– Banks governance should be reformed through accounting better for risk management, lowering bankers' compensation and tougher sanctions.

Some European countries have taken the lead without waiting for the potential introduction of European legislation based on this report. Thus, in July 2013 France adopted a "law of separation and regulation of bank activities", intended to implement François Hollande's commitment "to separate the activities of banks that are useful for investment and employment from their speculative operations".

However, the French government refused to call into question the universal bank French model. Speculative activities, narrowly defined, will not be banned from retail banks, but will have to take place in a subsidiary.

Thus, the law obliges banks to put in separate bodies their "without any link with the service to customers" market activities. Banks can continue to run operations "that are useful for the economy". But the notion of utility is not questioned. Is the development of financial activities useful? Should non-financial agents be encouraged to go in financial markets, to use toxic loans, structured investments, derivatives? Similarly, the customer's concept has not been specified in order not to apply to hedge funds and to speculative investment funds.

Banks have argued that this project could reduce the availability of credit. It's stupid because credit creates saving. Banks would have to lend directly to firms instead of transit through financial market or hedge funds. The prohibition of their speculative activities would sharply reduce the bank capital requirements.

In theory, activities for own account are prohibited, but the provision of financial services to customers (risk hedging), the coverage of the own risk of the establishment (interest rate or credit risk), market-making activity, the prudent management of cash and long-term investments remain permitted. Hedge funds detention is prohibited, as well as unsecured loans to these funds, but so-called secured loans are allowed. Packaging and marketing of structured financial products like derivative product remain at the level of retail banks. In total, the project isolates only 2% of banking activity.

Speculative activities must be restricted within an autonomous financial subsidiary. The latter will not be guaranteed by its parent (and thus by public authorities), should finance itself independently, can go bankrupt, and will need to develop a resolution scheme showing that its bankruptcy may be borne by creditors.

However, a prudential control and resolution authority (the ACPR, *Autorité de Contrôle Prudentiel et de Résolution*) will be settled. It may prohibit certain activities. The Finance Minister may require banks to limit the size of market operations carried out by the parent company.

The ACPR will manage a deposit guarantee and resolution fund (FGDR). Banks will have to develop a banking resolution plan which will have to be approved by the ACPR. A bank may be brought before the ACPR by the Bank of France Governor or by the Treasury Director-general. The ACPR will be able to remove the bank managers, to transfer the establishment, to make the FGDR intervene, to make the losses be borne by shareholders or creditors (subordinate or junior), to ask them to bring new funds, to prohibit the distribution of dividends, to appoint a provisional administrator, to suspend managers compensations.

The Financial Regulation and Systemic Risk Council becomes the Financial Stability Board. It will have the right to increase the capital requirements imposed on banks to prevent excessive credit growth or to prevent a risk of instability of the financial system. It will be able to set standards for the evolution of credit to avoid increases in assets prices or excessive indebtedness.

The French government refused to prevent banks from having activities in tax or regulatory havens, but banks will have to publish a list of their subsidiaries in foreign countries and the amount of their activities.

This French law may look strange insofar as it addresses issues which should be no longer under national legislation in two years, if the banking union is introduced. This law raises once again the issue of the link between national choices and decisions to be taken at European level. For example, the law gives the right to the ACPR to prohibit some too speculative activities but will that be possible if these activities remain authorized at the level of the banking union. Will the French Finance Minister still have any authority on banks in two years?

France is not the only country to have taken the lead. On 6 February 2013 the German government adopted legislation on separation of banking activities (*Trennbankengeset*). Retail activities should be separate from the activities for own account when the latter represent more than 20% of the balance sheet or more than 100 billion euros; banks will have to deposit a will. This law applies mainly to the largest two banks: Deutsche Bank and Commerzbank. It should be enforced from 2014, but banks will have an additional one and a half year to proceed to the separation.

In view of these national initiatives and the Liikanen report, the Commission of economic and monetary affairs of the European Parliament urges the European Commission to propose a European legislation for a separation of a Vickers' type of banking activities: activities necessary to the real economy must be protected in a legally independent framework within banking groups subsidiary. Restrictions on activities excluded from commercial banking would be stricter than in the French plan. It also calls for the use of internal bailout rather than the use of public funds.

5.3. Two European projects?

On 28 September 2011 the European Commission adopted a proposal for a directive on a common system of financial transaction tax (FTT). The European directive proposed to tax shares and bonds transactions at 0.1% and derivative contracts transactions at 0.01%. The gain was estimated to be 57 billion euro for the whole EU.

In the absence of a European agreement, and since August 2012, France has introduced a FTT, which includes a 0.2% tax on French shares purchases, a 0.01% tax on cancelled orders within *HF trading* in France, a 0.01% tax on naked CDS (which have been prohibited in France since 1 November 2012). The FTT was expected to raise EUR 1.6 billion in full year. However, according to Nyse Euronext, the amount of securities transactions subject to the FTT has declined by about 15% in two months. The French FTT does not apply to derivatives and some operators have therefore switched to this market.

A true FTT, applying to all banks and financial institutions financial transactions, would have three advantages: it would reduce the profitability of speculative activities, it would decrease financial markets liquidity, it would oblige banks to control better the operations of their market operators.

Eleven EU countries (France, Germany, Belgium, Portugal, Slovenia, Austria, Greece, Italy, Spain, Slovakia and Estonia) plan to introduce a FTT in the framework of enhanced cooperation. The European Commission assesses the potential gain of the tax at 30 to 35 billion euros (incorporating a decrease by 15% in the amount of the transactions).

Of course, the risk is high that European financial transactions are relocated in London and Luxembourg, but, in this case, the euro area will have to react, which will highlight the strategic differences on financial regulation within Europe. The banking union will have to choose between being an open area, with no specific rules, or a relatively closed zone, with specific rules.

Yet the Commission's text is designed to prevent delocalisation: taxation will apply if one of the parties to the transaction is established in a participating country, regardless where the transaction is made (residency principle) but also if the transaction involves a financial instrument issued in a participating country (residence principle). Will the text resist the pressure from banking and financial lobbies and from the UK? The UK has introduced a legal challenge against the FTT at the Court of Justice of the European Union? The French government is proposing a watered down version of the text that affect buyers of stocks and bonds, and not financial speculators.

European banks continue to have subsidiaries in tax and regulatory havens, particularly in Luxembourg, Switzerland, Guernsey, Jersey, Bermuda Islands, Cayman Islands… The reporting obligation (a bank must declare to the tax authorities of its residence country the financial incomes of their clients) faces opposition from Luxembourg, Austria, and Switzerland. Europe should widen the list of tax and regulatory havens countries, should prohibit European banks and firms to locate profits and operate in these countries, unless there is a specific justification linked to non-financial activities.

On these two issues, the banking union will have to make political choices. Who will have this responsibility in Europe?

5.4. What bank? what credit?

The problem remains: what financial system the euro zone need? Should we develop the ability of European banks to compete with the Anglo-Saxon institutions or should develop their role in financing the economy. Do we have to build a complex and unworkable regulation, which runs after the financial innovations? It would have been better that the European institutions adopt the clear objective to reduce the weight of finance in the economy. Some speculative activities should be prohibited; most speculative activities should be prohibited for the banking system; they should have be confined to specialized institutions, not guaranteed by the government, the cost of their financing would be high, which would reduce their profitability and their operations.

Europe needs a productive and industrial recovery. But it is necessary to define carefully the nature of this recovery. It must fit with the ecological transition. Industrial choices that engage future economic development cannot be left to shareholders, to the financial funds looking for short term profitability, or even to the large companies' managers. The society must guide the evolution of the industry towards green, efficient and innovative techniques, to promote energy savings, renewable energies, financing urban renewal and collective transports.

This is the industrial policy in the broad sense which must ensure productive recovery which should include:

- a product axis: to promote the production of sustainable products, compatible with ecological requirements;

- a planning axis: to collectively define the sectors to promote, to develop cooperative strategies between large companies and SMEs, between public and private research.

- a sectorial axis: to identify areas for the future and to maintain the basic economic sectors, which play a structuring role and which are rich in employment;

- a production axis: to improve the working community, the promotion and the training of employees rather than the financialisation, the business leader and the sprawl of the income hierarchy.

This ambitious strategy must be financed by national banks for sustainable development. They must develop a strong capacity for prospective; be able to take risks, on industrial, ecological and employment criteria and have a strong financial capacity both in equity and credit. Projects may be regional, national or European. The objective must be to collect a large part of the Europeans savings of Europeans, to compensate them at low but guaranteed rates. These banks must develop simple and short circuits between household savings and loans to productive sectors, to local authorities, and to housing. This project could give another dimension to the banking union.

6. Provisional conclusion

The challenge is huge: the euro area needs a strong banking system, able to finance growth recovery and to bring the economy out of the crisis. However, Europe has to make a clear political choice between two options.

A liberal one focuses on markets sentiment; banks are firms like any other firm; they must maximize their profit; they must be able to intervene freely on financial markets: they must be able to provide sophisticated investment and hedging tools to their customers. An unified European financial market will contribute to the European banking system regulation (see, for instance, Sapir and Wolff, 2013). However, the first risk is that banks prefer markets activities which are more profitable than credit supply. The second risk is that banks are weakened, see a rise in the cost of their resources, and need to reduce their credit activities under the effects of higher capital ratios constraints and higher risks for their creditors to have to give up their claims if the bank runs into difficulty. The third risk is that the link kept between banks and financial markets spreads outs financial markets instability into the real economy. The lending capacity of banks would depend on their solvency, thus on their own funds, so on the assessment of markets, with the risk of alternating between blindness and excessive distrust periods.

A more interventionist point of view stresses the need to protect credit and deposit specific banking activities, to isolate them from financial markets, to protect them by a public guarantee, to allow them to supply credit according to the needs of the economy.

Another choice also has to be done: a European banking system, unrelated with national agents and states, with a direct competition of all banks in the euro zone on unified basis; or the persistence of national systems, which would maintain a strong link with their territory. Will states tomorrow be able to intervene to influence bank credit, to rescue banks which are vital for certain sectors, to develop specific public banks? These choices cannot be left to the ECB, who is more concerned with the proper functioning of financial markets than with the real economy activity. These choices should not be hidden by short-term requirements as rescuing Spain. They must be the subject of a democratic debate in Europe.

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